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PRESENTATION

Operator

Good day, and welcome to ESCO Technologies Second Quarter Earnings Conference Call. Today's call is being recorded. With us today are Vic Richey, Chairman and Chief Executive Officer; Chris Tucker, Vice President and Chief Financial Officer.

And now to present the forward-looking statement, I would now turn the call over to Kate Lowrey, Vice President of Investor Relations. Please go ahead.

Kate Lowrey - *ESCO Technologies Inc. - Director of IR*

Thank you. Statements made during this call which are not strictly historical are forward-looking statements within the meaning of the safe harbor provisions of the federal securities laws. These statements are based on current expectations and assumptions and actual results may differ materially from those projected in the forward-looking statements due to risks and uncertainties that exist in the company's operations and business environment, including, but not limited to, the risk factors referenced in the company's press release issued today, which will be included as an exhibit to the company's Form 8-K to be filed. We undertake no duty to update or revise any forward-looking statements except as may be required by the applicable laws or regulations.

In addition, during this call, the company may discuss some non-GAAP financial measures in describing the company's operating results. A reconciliation of these measures to the most comparable GAAP measures can be found in the press release issued today and found on the company's website at www.escotechnologies.com under the link Investor Relations. During today's call, we will be referring to a slide presentation that is currently available on the Investor Relations section of our website. Within the call, the charts are located in the download tab at the top right corner.

Now, I'll turn the call over to Vic.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Thanks, Kate, and thanks, everybody, for joining today's call. I'd like to start off with a welcome to our new Board member, Jan Hess. We just finished up our Board meeting late last week and are really thrilled to be adding Jan to our Board. She brings a very broad skill set with decades of experience and leadership roles at Teledyne, a diversified industrial company. Her focus on technology development to meet customer needs and drive growth will bring great perspective to our Board. She also has experience across many industries, including several of our core markets. Her knowledge and leadership will be a great asset for ESCO, and we're happy to have her on the team. I'd like to thank the entire Board for their ongoing support and commitment to ESCO.

Now let's switch to discussion of the second quarter. Overall, we saw the business continue to build momentum. All 3 businesses delivered organic sales growth in the quarter. With consolidated revenue growth of over 23% in the quarter, it's clear that we have nice top line momentum. We also had another great quarter of order growth, with a 34% increase in orders compared to last year's second quarter. Our backlogs continue to grow with an increase of over $75 million since the fiscal year started. The backlog at the end of March was a new record for ESCO, so we feel good about the outlook for the balance of fiscal '22 and expect good momentum as we head into '23.

Chris will get into some of the financial details in a few minutes, but I'll start off with some top-level commentary about each of the business segments. Starting with A&D, where the quarter was a bit mixed. We continue to monitor the commercial aerospace business closely, and we're seeing some good growth from that market so far in 2022. It was another strong quarter for orders and revenue increased 30% over the prior year to reach the highest level since before the start of the pandemic. Some of this is from an easy comparison we had last year, but it's clear that travel is picking up, and that is helping drive recovery in our business.

The Navy and Defense businesses had some declines in the quarter, but we see that more as timing and feel good about the outlook there. While there was revenue growth in the quarter, there's still margin and operational challenges in A&D. Past due backlog is something we're watching closely as supply chain challenges have not let up. So all of the operations teams are highly focused on managing these issues to support our customers. On the margin side, the bottom line for A&D is we expect margins to improve as recovery continues and volumes build in the back half of the year.

Let's turn now to the Test business, where we had a really great quarter. The sales growth strength continued with nearly 28% increase compared to last year's second quarter. We've seen great growth in the Americas and in Asia with the growth coming from several key industries and product lines. The other thing I'd like to highlight about the Test quarter is the margin performance. We talked a bit last quarter about how important it was to see the margin improvement in this business, and it really came through nicely in the second quarter. The team at Test continue to work the inflation challenges aggressively. It's definitely an ongoing battle, but nice to see the jump in margins after all their hard work.

Similar to Test, we had a really solid quarter from the USG business as well. The underlying sales growth came in at over 35% in Q2, just phenomenal growth. And when you add in the acquisition impact, the growth jumps to north of 60%. Really great work by the teams there. And we had a pretty weak quarter for Doble a year ago. So the comparisons were bit easy, but I would say, we still saw the orders and sales momentum outpacing our expectations as the quarter closed out.

I did want to comment on the acquisition integration status for Doble, Altanova and Phenix. We just did a strategic review with these teams a few weeks ago, and they've really done a great job of analyzing the product portfolio to determine which products should be offered in our markets around the world. Clearly, the acquisitions have brought us some new capabilities. And now, we have good visibility on our product road maps globally. It's a long process and it will be additional work as we move into execution mode, but we still see nice revenue synergies and are really happy of how the businesses are coming together.

Overall, through the first 6 months of the year, we feel good about what we achieved and we continue to be on track with the expectations we laid out back in November. It does require a step-up in EPS growth in the second half of the year. This is how our plan was laid out from the beginning of the year, and we've been working hard with all our subsidiary teams to make sure the plans are in place to deliver. You all know that the operating environment is very challenging, right now, but we will continue pushing hard to deliver the year. Certainly, the backlogs are supportive of the second half projections, and we are committed to delivering for our customers.

And now, I'll turn it over to Chris.

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Thanks, Vic. So I'll go through the financial results now. We're going to do that with the slide deck this time. We created a slide deck that you should be able to see on the webcast, and you can also access from the Investor Relations section of our website, as Kate mentioned earlier.

Starting first on Chart #3. You can see on all the significant measures, we had nice double-digit growth. First, with orders, 34% increase this quarter versus the quarter a year ago. The book-to-bill of 1.15x was very strong and driven really by broad strength across the business. And we finished with record backlog at $671 million as of the end of March. Sales increased by 23.5%. That was built up with 16.5% organic growth and then acquisitions, adding another 7 points of growth. So, again, we saw nice sales growth and really good strength from utilities, commercial aerospace and also in the test group.

On the adjusted EBIT dollars we were up 17%. We did see the margins drop a little bit. We'll go through that segment by segment. But fundamentally, we had A&D down a little bit and then good improvements from Test and USG. And then, if you look at the GAAP EPS, you can see, we were at $0.59 a year ago in the quarter. On an adjusted basis, that came down to $0.56. You'll recall that a year ago, we had a gain as we resolved the Watertown building. And so that gain was put out of the numbers a year ago. This year, we had $0.01 for various different adjustments. So that gets you to $0.65 this year versus $0.56 a year ago or a growth of 16%.

If we go to the next chart, we'll have a little look at cash flow here. We are down in cash flow year-to-date. So through the first 6 months, we're at $23 million versus just over $57 million a year ago. A couple of key things to point out in the balance sheet changes that are driving that. First is kind of our contract assets and liabilities that you see on the balance sheet. We have various milestone payments that we receive as our contracts are executed on. Last year, we had some pretty big payments come through. This year, we haven't had those yet. It's really just an impact of timing. So we would expect that to level out as we move forward.

The other big impact is inventory. That's hurting us by about $18 million year-over-year. A couple of things going on with inventory. First, as you all are aware, we're managing a lot of supply chain issues, as is everybody out there these days. What that means is sometimes to secure parts, we're maybe buying quantities that are a little bigger than normal. Other times, we might have most of the parts we need to finish an order, but not all of them, so we can end up with a little bit of stranded inventory.

And then, the other big factor is just the increased backlogs. I mentioned, we have record backlogs right now. So we're bringing in a lot of inventory to get ready to kind of flush that backlog out as we move into the back half of the year. So those are the big drivers on the inventory impact to cash flow.

The other items on this page, capital expenditures were up about $7.5 million year-to-date. That really is driven by the Q1 purchase of the NRG headquarters, which we discussed 3 months ago. On the acquisition side, we've spent $15.6 million this year. That was for the NEco acquisition in the A&D group. A year ago, we had done the ATM acquisition, also in the A&D group, for $6.7 million. Lastly, it's the share repurchase. You'll recall back that in November, we were reauthorized to spend $200 million on the new program. For the first time in several years, we started the buybacks again this year, and we've spent approximately $18 million year-to-date.

If you go to the next page, we'll go through the segment performance. Starting first with A&D. So you can see that the orders here were up 7%. If you look at the bottom right of the chart, you see the backlog at almost $397 million, which is nearly a 14% increase from a year ago. So we still have very healthy backlogs here really across the business, but certainly the commercial aerospace with many of the different platforms inside of there has begun to recover nicely. And that's a key driver in the numbers you see here.

Same with sales. The sales growth was 3% overall. Commercial aerospace really led the growth in this quarter. As Vic mentioned, we kind of had some easier comparisons right now, because last year was very weak. But no doubt, we're seeing those businesses start to come back a little bit. Navy was actually -- we saw growth there from the Globe and Westland businesses, but VACCO had some pretty big declines in their Navy business, again, kind of timing as they execute against some of their contracts. So they were -- overall, the Navy business was slightly down for us in the quarter

And then if you look at the EBIT margins, you can see at 17.1%, down from 20.7% a year ago. I mentioned the VACCO sales decline. So we did have some deleverage on that and a little bit of mix inside of the commercial aero businesses being the main drivers for the margin decrease. If we go to the next page, we have the Utility Solutions Group, really just a great quarter across the board here. Starting with orders. The orders almost doubled. So you can see 98% growth, that was built up with about $27 million of growth from the core Doble business, $12.6 million contributed from the acquisitions, and then the renewable business grew by $3.2 million.

On the sales side, we were up 62%, Doble organically was up 39%, Altanova and Phenix added $10 million and then NRG was up 23%. So we continue to see good strength in the renewables market. I would also point out here that year-to-date, if you exclude the acquisitions, we're up 9%. So you'll recall that in the first quarter, we were pretty weak organically, a big recovery this quarter. And year-to-date, we're seeing solid growth there.

Adjusted EBIT margins were up almost 4 points, so 17.7% compared to 13.8% a year ago. So obviously we saw good leverage on the revenue flow through. We are putting some price increases through here, which are helping to more than offset the wage and material inflation we see. We're also starting to incur some expenses related to trade shows and customer events that we're now doing in person. So that's bringing back a little more cost than we had in the prior year

If you go to the next page, with the Test business, similar to USG, just really strong performance here across the board. Orders up 25% to $55.4 million. We're really seeing strength domestically in the medical shielding, and then globally, we're seeing good order input across the test and measurement project business. From a sales perspective, we were up 28% to $55.9 million. We've talked before about some of the power filter orders that have been coming in, definitely starting to see those flow out of backlog and into the sales line and really seeing broad strength in the US and in China in that business. On the margin side, we're up over 2 points to 15.2%. Again, it's a volume and price impact, definitely still fighting inflation here as well on the material side and the wage side, but with the big growth in the price increases, we're able to drive the margin increase.

So if we go to the last page, just a quick discussion on our guidance. Vic had mentioned this a little bit. But fundamentally, we came out with guidance for the full year back in November of $3.10 to $3.20 per share. I would say, in the first quarter, we probably came in a little light of expectations. During the second quarter, we outpaced expectations a little bit. So we're really pretty much on track through the first half of the year, and we feel like the full year range is still appropriate. That leaves us for the third quarter then with solid growth projection of 25% to 35% or a range of $0.84 to $0.91.

So that's really all I had on the financials, and I'll turn it back over to Vic.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Thanks, Chris. Since I touched on quite a few of my thoughts early in my commentary, I'll just offer 2 more comments before we move into Q&A. We feel good about the start to 2022, and we're excited about the forecast we have out there. Lots of growth coming as we move into third quarter and beyond.

We recently had our planning meetings with all the businesses. All the subsidiary teams have great product development programs that they're pursuing to deliver growth over the 3-year planning horizon. The end markets we serve continue to recover and exhibit good growth characteristics over the short to medium term. Our portfolio is well positioned as we move forward. There continues to be uncertainty in the economy as the pandemic continues to evolve. But as always, we'll focus on serving customers well or managing our profitability and balance sheet to deliver higher returns for the shareholders.

To close out the opening commentary, I'd just like to thank all of our employees for the tremendous efforts so far this year. We all know how challenging an operating environment is. There are lots of challenges to run an efficient operation right now. Supply chains continue to be unpredictable and getting certain operations fully staffed is also challenging. In spite of all that, our teams have -- for that, I'm very grateful. I just want to extend a big thank you to the entire ESCO team.

So with that, I think we're ready for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from John Franzreb with Sidoti & Company.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

I'd like to start with the supply chain issues that you had with the contractor in the previous quarter. I'm just curious, you said those might linger into this quarter. Did they -- to what kind of magnitude did they linger?

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Yes. What I would say, John, is that we did see those past due backlogs continue to increase. So we talked a little bit last quarter about missing some sales as a result of that. So that overhang is still there. And I think we were able to kind of power through that and still obviously drive to the earnings and sales commitments we have made. But I think, from our perspective, we're watching the supply chain close and kind of expect everybody is working to burn the past dues down as quick as we can. Obviously that's important to keep our customers happy. But we expect that's a challenge we're going to have for probably the balance of the fiscal year. And again, everybody has got plans to get those past dues down, but we did see an increase in the quarter, and we'll continue working down from here.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Yes, I'd just add. I think it's a constant dance for sure, because you don't know what's going to not show up from one day to the next. And the other thing that -- in addition to this normal supply chain, as you would think about with piece parts, in our Aerospace and Defense Group, we're really challenged on outside processing. Because you know a lot of the products we make, there a lot of other -- you had to [send it out], have some processing done, it comes back. And the lead times on the outside processing have been increased dramatically and it's something that we would typically get back in 2 weeks. It may be taken 12 weeks. And so, it's just -- it's really a dance.

But as Chris said, I think the good news is, we've kind of dealt with those challenges. We've done a lot of work around pulling some things in. And so, we really do need to get that worked off, but we'll get that done over time for sure. And having that big backlog that we have now is really helpful because you have a little more flexibility to pull things in, if you need to do that.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

Right. Right. Great. And just to shift over to Altanova and Phenix, I'm wondering if you've identified any additional revenue synergies or cost saving opportunities as you've kind of got to know the businesses a little bit better?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Yes, I think the biggest opportunities for us there are really doing some cross-selling. So, as I talked about in all the comments, they've done really a lot of really good work to go through in each of the product areas. Look at the products trying to figure out the best characteristic of each of those and then working to make sure that we're selling the right products in the right area. When we made the acquisition, part of our internal review was what type of revenue synergies and other types of synergies we'll be able to get. And I would say, we have a lot of confidence that we're going to be able to achieve those based on the work that's been done so far.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

Okay. And just the legacy USG business, can you talk a little bit about the relative strength in the business and how much confidence you have in that persisting through the balance of the year? It seems like a really good come back there at Doble and everything.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Yes, it was. We were really disappointed going into the first quarter. And so, we've really seen a lot of strength here. And so a lot of it is anecdotal, if you will, because we do survey our customers to understand where they're at. People are getting back in the office. The number of people that are saying, yes, we're going to buy test equipment is probably up 40% from when we last did that. And so, it does seem like -- I don't think it's going to be linear, if you will. I mean, I think -- but I do think that the momentum is there, and we're going to see that throughout the year. And again, the backlog in that business is probably as good as it's ever been. And so, I think just -- we just need to keep the momentum going. I think it's there. We always do this big customer conference every spring. So we did that in person this year for the first time, obviously, in a couple of years. I would say attendance was lower than it has been historically, but still pretty robust. And I would say, the people who were there were very engaged, and I think very excited about some of the things we're doing. As we've talked about in some of the earlier calls, we have introduced a number of new products. And I think that's part of what's getting the momentum for us is having some updated products we're able to get to the customers.

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Yes. And I would just add. I mean, I think, as Vic said, as we talk to the team there, they do feel like sentiment is starting to improve a little bit. Some of the external forecasts they track as well on overall utility usage continue to increase. So, I think there just seems to be a little bit better of kind of overall outlook for demand, and we kind of see that in some of the customer activity and interactions right now. So, as you mentioned, John, I mean it's -- and as Vic said, it's maybe not going to be perfectly linear, but we're hopeful to get to kind of a more stable, steady growth output as opposed to kind of a lot of the up and down we've seen over -- really through the whole pandemic.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

Great. I'll get back in the queue.

Operator

(Operator Instructions) Our next question comes from Jon Tanwanteng with CJS Securities.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

My first one is on, maybe just to dig a little deeper to Doble. I was wondering if the demand you're seeing so far has sustained into Q3. I think you suggested you might have #1 and #2, is it some of that pent-up demand where they're just catching up to where they needed to be? Or is that more just a resumption of the demand you saw pre-pandemic?

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

I didn't hear your first question, I'll answer your second one. I do think it's more just returning to normal. I'm not sure there's a huge amount of pent-up demand. I mean, with the test equipment, there's some discretionary nature to it, but it does seem like its getting back to where it was prior to the pandemic. So I think it's more something that's sustainable. I mean, if there were too much pent-up demand, I'd be concerned because that would be kind of a bubble, and we see this more as a recovery to the norm.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Got it. And the first part was just, have you seen that sustained through Q3 so far?

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Honestly, we don't even have our first month yet, but -- so it's hard for us to comment on kind of what we've seen in April so far. The only thing I would point out, Jon, is that we had -- we are seeing some pretty big orders right now too for some of our like lease renewals. And we mentioned in the press release that we had one of the big DUC orders, which is the Doble security offering. Those are great programs for us, but those are also kind of like they can be multimillion-dollar type orders that sit in backlog for a while. You're going to execute those things over anywhere from a year to all the way up to 5 years. So we did see some pretty big of those in the quarter, which helped drive the orders. And again, that's a positive thing, but I just wanted to give you some of that color on what happened in the quarter.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Got it. That's helpful. My next question, just -- on the ability to meet those orders. I think you mentioned in the past quarter and maybe even before that, the Doble had some issues. Acquiring electronic parts, we know China has had lengthening lockdown. I'm just wondering if you're able to actually meet that demand that you have now.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Yes, I think we'll be okay. I mean, like I mentioned earlier, we may be delivering slightly different mix of products than what we had anticipated. But they're working through these issues, but they're not insignificant, but they work hard on finding things in a great market and through reps and things like that. So you can find it, but it's just a lot more work than it used to be.

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Yes. And I would say, when we disclosed last quarter, Jon, I think we said $5 million to $8 million that we had missed because of some of the past due backlogs. Doble was part of that. And their number inside of that build up did get bigger here in the second quarter. So they still have -- and they're used to kind of having 0 past due. Typically their stuff kind of comes in and goes out from an order perspective with a lot of their boxes they sell. So they are definitely still seeing some supplier issues with the chips and other things that they need. But again, a lot of other demand obviously that allowed them to have such a strong top line, but no doubt the supply chain is still kind of holding us back there slightly.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Okay. Great. Understood. And then, my last question, just -- could you talk about your preference for share repurchases now versus potentially more M&A at this point?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Well, I think we always would prefer to make good acquisitions, and we'll continue to look for things there. I mean, I think we are a little more aggressive than we have historically on the stock. Because we didn't really even kind of clean up our dilution for a number of years. And so we certainly want to do that. It's something we talk about every quarter. It really is kind of based on what we see from opportunities for acquisitions. And so, we review that on an ongoing basis. So, if we aren't able to achieve some of those things, then we'll look at being more aggressive on the buyback side.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

How does the pipeline look now?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Pretty good. I mean, it seems like over the past few months has picked up a bit, some interesting properties out there. So nothing that's going to close this week. But there's a number of things that we're working on.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Okay. Thank you, guys. I'll go back in queue.

Operator

Thank you. I'm currently showing no further questions at this time. I'd like to hand the conference back over to Mr. Richey for any closing comments.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, President & CEO*

Okay. I appreciate everybody's participation, and we'll end the call now. And thanks for dialing in. We look forward to talking to you in our next call.

Operator

Ladies and gentlemen, thank you for your participation. You may now disconnect. Everyone, have a wonderful day.
